

# SPOTLIGHT

## Staff Update and Preview of 2020 Inspection Observations

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October 2021

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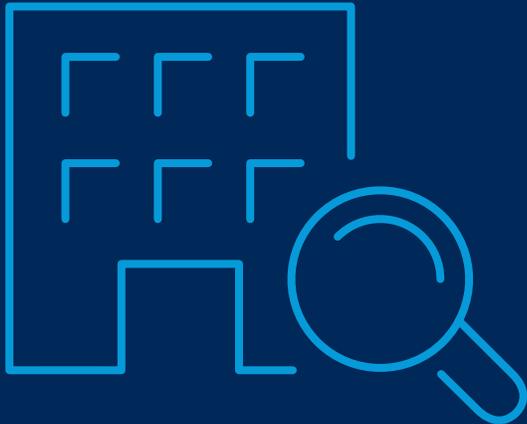
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## 2020 INSPECTIONS OBSERVATIONS AT A GLANCE

### PCAOB 2020 Inspections By the Numbers



**114**

U.S. audit firms  
inspected, with

**510**

audits reviewed

**39**

non-U.S. audit firms  
inspected, with

**107**

audits reviewed

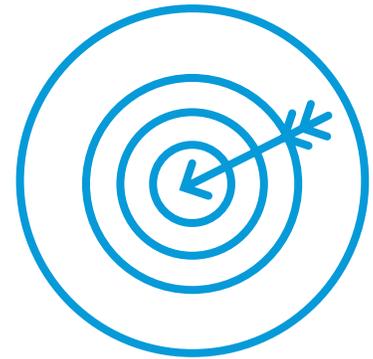
### Key PCAOB Observations from 2020



We continue to identify a number of deficiencies that recur from year to year.



For the majority of the annually inspected audit firms, we identified fewer findings in 2020 compared to our 2019 inspections. In our triennially inspected audit firms, some improvements were noted, although deficiencies continue to remain high.



We also observed a number of good practices that we believe may be effective in enhancing audit quality.

## Areas of Common Deficiencies in 2020



Internal Control Over Financial Reporting



Revenue and Related Accounts



Accounting Estimates



Inventory



Critical Audit Matters



Independence

## Good Practices Observed at Audit Firms in 2020



Incremental steps in response to the COVID-19 pandemic, including increased training and assistance, emphasis on consultations, and modified client acceptance and continuance procedures.



Real-time monitoring of in-process audit engagements.



Increasing supervision of the work performed by specialists.



Use of practice aids to assist engagement teams in identifying risks for each factor relevant to management's estimation processes.



Monitoring workload and expertise of engagement quality reviewers and hiring qualified and experienced third-party engagement quality reviewers, when necessary.



Providing focused industry training and tailoring work programs dealing with industry-specific risks and issues.

## OVERVIEW

In 2020, the Public Company Accounting Oversight Board (PCAOB or “the Board”) inspected 153 audit firms, reviewing portions of 617 audits that generally had financial years ended during 2019 and the first half of 2020.

This Spotlight presents our aggregate observations, which we share as a preview of the inspection reports that we will publish for individual audit firms.

In addition to results from our 2020 inspections, this Spotlight also provides certain comparative data from our 2019 and 2018 inspections.

Auditors may find this information useful as they plan and perform their audits, and audit committees may benefit from the use of this publication as a reference point when engaging with their auditors. We also believe this information may help investors and other stakeholders become more fully informed about the matters we find in our inspections.

### Brokers and Dealers

Information for auditors of broker-dealers, including annual reports on the interim inspection program, is on our [website](#).

## CHANGES IN OUR INSPECTION APPROACH

The PCAOB took steps in our inspection program to address the challenges of the COVID-19 pandemic. Some of our responses to the COVID-19 pandemic included conducting all inspections remotely, adjusting our

## PCAOB Inspections: The Basics

The PCAOB is committed to improving audit quality and ensuring compliance with professional standards and rules. One way we do this is through our inspections of firms that audit public companies listed on a U.S. exchange. Those audit firms are required to register with us, as explained in more detail on our [website](#).

The actual number of registered audit firms subject to inspection changes each year based on firms’ issued auditor’s reports and in accordance with rules of the Board. We design our inspections to review portions of audits selected for review and evaluate elements of an audit firm’s quality control (QC) system.

As our inspection process evolves over time, it can, and often does, include a different mix of audits and focus areas from year to year and firm to firm. These variations may affect the comparability of inspection results over time.

inspection approach to consider the impact of COVID-19 on the audits of public companies, refining our planned QC procedures, and providing insights to inform stakeholders on the PCAOB’s oversight activities related to the COVID-19 pandemic.

As we executed our 2020 inspection plan, we tailored or enhanced certain aspects of our inspection procedures. For example, we took discrete steps to understand audit firms’ considerations of, and responses to, the effect of the pandemic on audits of financial statements and internal control over financial

reporting (ICFR) and reviews of interim financial information. Our procedures included reviewing audit firms' publications and internal guidance that specifically addressed aspects of the audit most likely to be affected by the pandemic.

We also accelerated our selection and review of audits potentially impacted by COVID-19 by selecting a sample of audits of public companies with fiscal years ended primarily between March 31, 2020 and June 30, 2020, (i.e., so that we could understand sooner how audits were being performed during the pandemic). If we had taken our usual approach in 2020, we would not have started reviewing public company audits potentially impacted by the COVID-19 pandemic until 2021.

The challenges in 2020 also prompted us to supplement our planned QC procedures by placing increased focus on reviewing changes made by audit firms to their QC systems in response to the COVID-19 pandemic.

At the onset of the pandemic, we provided registered audit firms an optional 45-day deferral from inspections. Apart from this, no other modifications were made to reduce the obligation of audit professionals to observe the PCAOB's rules and other professional standards. Our observations and reminders for auditors are more fully described in the December 2020 Spotlight, *Staff Observations and Reminders during the COVID-19 Pandemic*.

## COMMON DEFICIENCIES

Included in Part I.A of our inspection report are observations concerning audit deficiencies that are of such significance that we believe the audit firm, at the time it issued its

audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion on the financial statements and/or ICFR of the public company. If we include a deficiency in our inspection report — other than those deficiencies for audits with incorrect opinions on the financial statements and/or ICFR — it does not necessarily mean that the public company's financial statements are materially misstated or that undisclosed material weaknesses in ICFR exist. It is often not possible for us to reach a conclusion on those points based on our inspection procedures and related findings because, for example, we have only the information that the auditor retained and the public company's public disclosures. We do not have direct access to the public company's management, underlying books and records, and other information.

In Part I.B of our inspection reports, we provide observations regarding instances of noncompliance with PCAOB standards or rules that do not relate directly to the sufficiency or appropriateness of evidence the audit firm obtained to support its opinion(s), such as critical audit matters, Form AP, and certain independence related deficiencies.

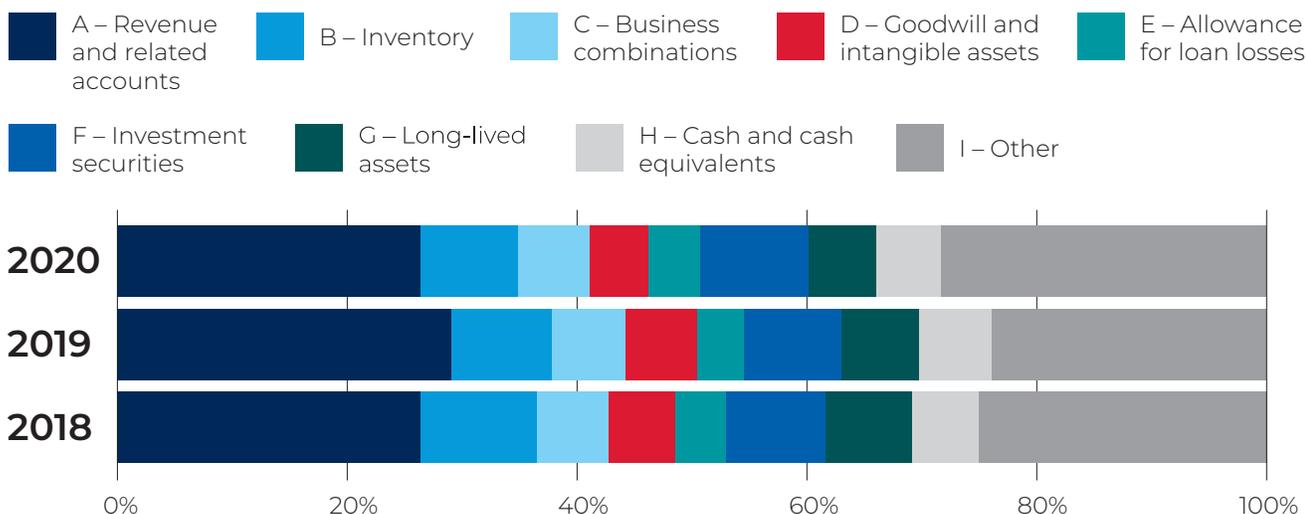
## 2020–2018: Common Deficiencies

### Deficiencies in Auditing Financial Statement Areas

In our continuing efforts to monitor areas with recurring deficiencies, we analyzed our last three inspection cycles beginning in 2018 to look for trends in the deficiencies identified related to auditing financial statements. The results highlighted the following financial statement areas that generated the most "comment forms" (the initial communication to

audit firms of observed deficiencies from our inspections, which generally result in Part I.A or Part I.B inspection observations) on a recurring basis during this period:

### Common Financial Statement Deficiency Areas, Excluding ICFR

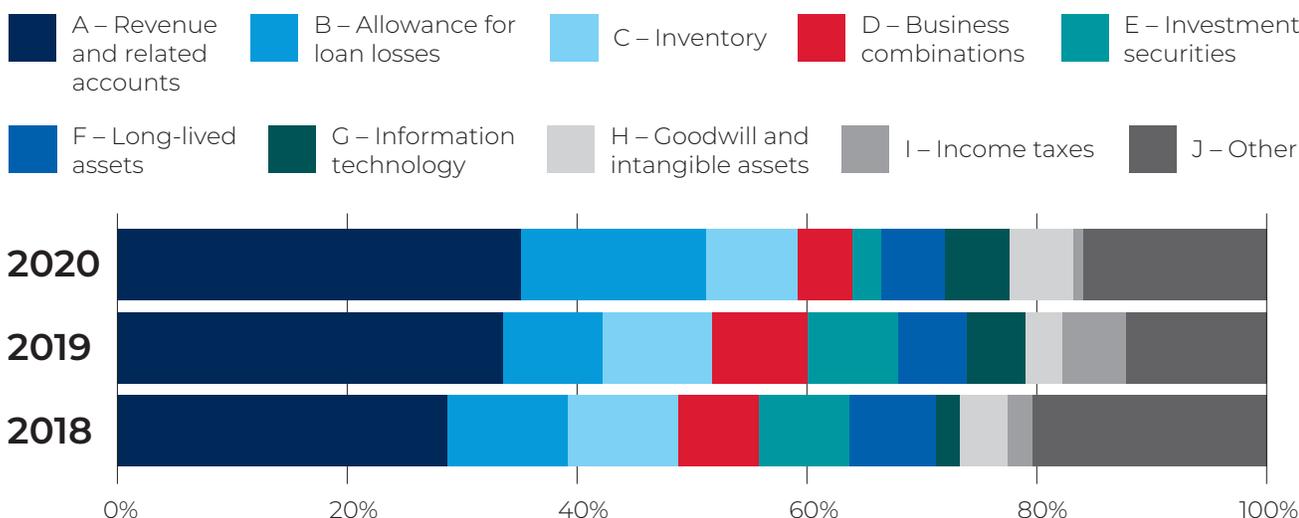


### Deficiencies in Auditing ICFR

Our continuing efforts to monitor areas with recurring deficiencies also considered comment forms related to the sufficiency and appropriateness of audit evidence supporting an audit firm’s ICFR opinion. These deficiencies represent instances of noncompliance with AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

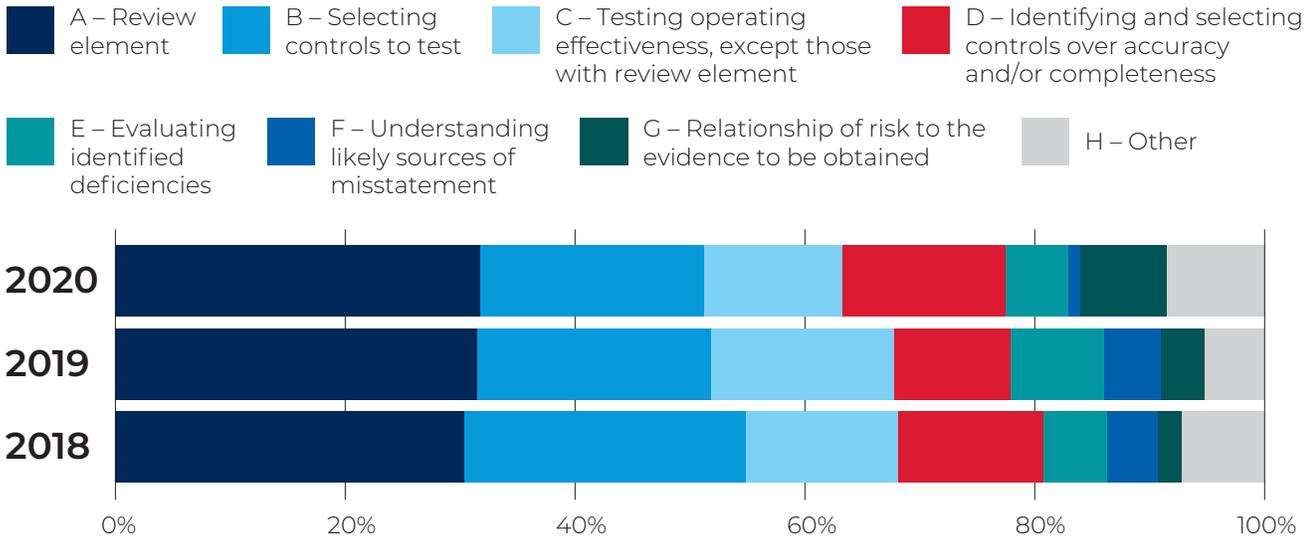
The accompanying chart illustrates the financial statement audit areas to which our ICFR comments relate.

### Deficiencies in Auditing ICFR by Financial Statement Area



Further comparison of the three-year data highlights certain areas in ICFR audits that generated the most comment forms since 2018. The chart below illustrates the areas of an ICFR audit to which auditing deficiencies relate.

### Nature of ICFR Auditing Deficiencies



Auditors are encouraged to continue to focus on auditor performance in these areas. Guidance on performing audits in accordance with AS 2201 can be found on our [website](#).

### Common Deficiencies From 2020

In 2020, we observed deficiencies similar to those identified in prior years, including ICFR. Many of these deficiencies are in areas that are inherently complex and in turn have greater risks of material misstatement. The auditor must plan and perform audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for his or her opinion. As the assessed risk of material misstatement

increases, the amount of evidence that the auditor should obtain also increases.

### Revenue and Related Accounts

Revenue continues to be a frequently selected focus area in our inspections due to the complexity around a public company's recognition of revenue and, in turn, the challenges related to auditing this area.

Despite the focus and attention by audit firms on the new accounting standard,<sup>1</sup> as well as the training and/or tools audit firms provided to their auditors, we observed frequent deficiencies related to the design and performance of audit procedures to identify and address assessed risks of

<sup>1</sup> On May 28, 2014, the Financial Accounting Standards Board completed its Revenue Recognition project by issuing Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606). The new guidance on revenue recognition was effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period.

material misstatement related to revenue. For example, we identified audit deficiencies in testing revenue accounted for under the new accounting standard where:

- In determining revenue based on transfer of services provided to customers, the auditor did not evaluate whether the performance obligation for the services was satisfied before revenue was recognized.
- The auditor did not evaluate whether customer contracts met the collectability criteria required to identify a contract with a customer.
- In determining revenue based on performance obligations satisfied over time, the auditor did not obtain sufficient appropriate audit evidence from the related measure of progress, including the reasonableness of the total expected cost to satisfy remaining performance obligations (input method) or the accuracy of the estimated total units to be completed (output method).

Other common deficiencies in auditing revenue include instances where auditors, in performing tests of details or substantive analytical procedures, did not test, or did not identify and test any controls over, the accuracy and completeness of data or reports produced by the public company used in their testing.

In addition, we observed some auditors have implemented the use of technology-based data analysis tools when auditing revenue, such as in audits of public companies that sell or distribute goods. These tools enable auditors to perform transaction testing by analyzing the relationships among revenue, accounts receivable, and cash receipts in complete populations; and, identifying anomalies for investigation.

Common audit deficiencies observed when using such data analysis tools include instances where:

- Auditors did not sufficiently validate the accuracy of the information used in the analysis.
- Auditors did not sufficiently evaluate exceptions identified when testing whether cash transactions represented cash collected and applied to outstanding invoices related to such revenue. In some instances, the auditor only agreed the cash received to an unapplied cash account.
- Auditors did not appropriately execute their audit firm's established policies and procedures when conducting testing to validate the accuracy and completeness of information produced by the public company used in the various analyses.

As a reminder, when using information produced by the public company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to (1) test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and (2) evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

## Accounting Estimates

Most, if not all, financial statements contain accounting estimates — which in turn involve subjective assumptions and measurement uncertainty — and present heightened risks of material misstatement.

While we have observed improvements in auditing accounting estimates, deficiencies continue to occur, particularly in auditing the allowance for loan losses (ALL),

estimates related to accounting for business combinations, investment securities, and long-lived assets. Common deficiencies in auditing estimates included instances where:

- Auditors reviewed management's memorandum describing assumptions used in determining the ALL but did not evaluate evidence supporting certain assumption changes from the prior year, or lack of changes, when evaluating the reasonableness of such assumptions.
- Auditors did not obtain sufficient appropriate audit evidence to support the assumptions used, or perform procedures to resolve any known contradictory evidence, when evaluating the reasonableness of financial statement forecasts used to determine the fair value of certain acquired assets.
- Auditors did not evaluate the appropriateness of the valuation models and the reasonableness of significant assumptions used by the public company in determining the fair value of investment securities.
- Auditors did not perform sufficient procedures to resolve any known contradictory evidence when evaluating the recoverability of certain long-lived assets.

New requirements for auditing accounting estimates, including fair value measurements, and for using the work of public company and auditor specialists are effective for 2020 calendar year-end audits. Our observations in this Spotlight relate to requirements that were applicable before these changes.

## Inventory

Many public companies perform cycle counts of their inventory rather than performing an annual physical count of each item of inventory. When cycle counts are performed, the auditor must understand if the public company's controls and procedures are sufficiently reliable to determine inventory quantities that are substantially the same as those obtained by an annual physical count of all items. The auditor must be satisfied that the sampling plan is reasonable and statistically valid, that it has been properly applied, and that the results are reasonable in the circumstances.

In certain instances, auditors selected for testing controls over the existence of certain inventory, which consisted of review of cycle count results to assess the reliability of the program. The auditor limited their procedures to inquiries of management and did not perform procedures to satisfy themselves as to whether the cycle count program produces results substantially the same as those that would be obtained by a count of all items each year.

## Critical Audit Matters

The requirements in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to determine and communicate critical audit matters are now effective<sup>2</sup> for audits of all public companies to which the requirements apply. Critical audit matter communications are intended to inform investors and other financial statement users about matters that required especially challenging, subjective, or complex auditor judgment, and the auditor's response to those matters.

<sup>2</sup> The requirements related to critical audit matters were effective for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after Dec. 15, 2020, for all other companies to which the requirements apply, as described in the standard.

In 2020, we reviewed approximately 200 audits in which auditors were required to communicate critical audit matters in an auditor's report. Those approximately 200 audits consisted principally of the audits of large accelerated filers that we inspected in 2020, as those were the audits to which the critical audit matter requirements were applicable at that time. Common deficiencies in this area include instances where:

- Auditors performed procedures to determine whether or not matters were critical audit matters but did not include in those procedures one or more matters that met the criteria as a potential critical audit matter. These instances of noncompliance do not necessarily mean that other critical audit matters should have been communicated in the auditor's report.
- Auditors, when communicating a critical audit matter in their reports, did not accurately describe (1) how the critical audit matter was addressed in the audit or (2) the principal considerations that led the auditor to determine that the matter was a critical audit matter.

For matters required to be assessed, auditors are reminded that they must document whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.

## Form AP

Registered audit firms are required to submit Form AP, *Auditor Reporting of Certain Audit Participants*, to disclose the names of engagement partners and other accounting firms that participated in their audits of public

companies. Common deficiencies include instances where auditors did not file, or timely file, their reports on Form AP; and where an auditor's Form AP either contained inaccurate information or omitted information related to the participation in the audit by certain other accounting firms.

## OBSERVATIONS RELATED TO QUALITY CONTROL

We perform QC procedures to obtain and/or update our understanding and assess the effectiveness of an audit firm's QC system. Some of our procedures focus on specific QC system areas across all firms, while other procedures are customized for each inspected firm based on the firm's structure and size, past and current inspection observations, procedures performed in prior inspections, and other factors.

Our assessment of a firm's QC system is derived from results of our QC procedures as well as from analysis of the deficiencies identified in individual audits. We also consider other available information (e.g., results of an audit firm's internal inspections, securities regulator investigations, and enforcement actions) that may provide evidence as to the effectiveness of a firm's QC system.

In 2020, for certain annually inspected audit firms, we refined our inspection procedures with increased focus on QC system areas most likely to be affected by the pandemic, including consultation requirements, client acceptance and continuance procedures, real-time audit engagement monitoring, and pre-issuance reviews.

We noted the following QC concerns based on our procedures:

## Independence

Independence is a critical element to be addressed by a firm's QC system and remains an area for improvement. In 2020, we continued to identify violations of financial relationship requirements of Rule 2-01 of Securities and Exchange Commission Regulation S-X. Certain inspected audit firms continue to report a high rate of noncompliance by audit firm personnel reporting their financial relationships into the audit firm's monitoring systems. We also observed deficiencies related to PCAOB Rule 3524, *Audit Committee Preapproval of Certain Tax Services*, and PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*.

## Engagement Quality Reviews (EQR)

EQR remains an area of concern. We continue to observe instances where we identified deficiencies through our inspection procedures in areas that require the engagement quality reviewer's evaluation; for example, in areas where the engagement team identified a significant risk, including in some cases, a fraud risk. In addition, in certain audit firms, the engagement quality reviewers did not maintain objectivity in performing the review, as they assumed responsibilities of an engagement team member and performed audit procedures, or had served as the engagement partner during either of the two preceding audits.

## Internal Monitoring

We also observed situations where we identified deficiencies through our inspection procedures that were not identified through

an audit firm's internal inspection procedures directed to the same engagements. Such results may indicate that the audit firm's QC system related to monitoring does not provide reasonable assurance that the audit firm's internal inspection program is suitably designed and/or being effectively applied.

## OBSERVATIONS OF GOOD PRACTICES

Through our inspections, we observed good practices we believe may enhance audit quality. We share this information given our strategic objective to communicate information that may correlate with the quality of audits.

### What Is a Good Practice?

A good practice could be a procedure, technique, or methodology that is appropriately comprehensive and suitably designed in relation to an audit firm's size and the nature and complexity of the audit firm's practice and that may contribute to the quality of audit services.

We observed one or more of the following steps taken by audit firms in their QC systems in response to the COVID-19 pandemic:

- **Increased training and assistance** – Audit firms conducted training sessions focused specifically on addressing the challenges of performing audits remotely, and on areas more significantly impacted by the pandemic (e.g., impairments and going concern). They established resource centers to facilitate the use of interactive audit tools. They also developed practice aids and

other guidance to focus audit teams on potential issues related to the pandemic that may affect a public company's financial statements or ICFR.

- **Emphasis on consultations** – Audit firms emphasized the importance of consultation and, in some cases, established supplemental consultation requirements including, for example, for issues related to government assistance, changes to materiality, market and business changes impacting accounting, impairment evaluations, and going concern assessments.
- **Modified client acceptance and continuance procedures** – Audit firms added new sections in client acceptance and continuance questionnaires to focus specifically on risks presented by the COVID-19 pandemic. For example, explanations were required for risks factors with potential increased significance due to the pandemic (e.g., liquidity concerns or negative operating results).

In addition, other good practices we observed include:

- **Real-time monitoring of in-process audit engagements** – Certain audit firms have increased the level of real-time monitoring of audits, such as implementing pre-issuance reviews or coaching programs. Additional oversight of engagement teams from qualified and experienced personnel outside the engagement team may provide an objective perspective as to whether the audit evidence obtained by the engagement team is directly responsive to the risks identified and sufficient and appropriate. Performing monitoring activities for audits in process enables deficiencies to be identified and remediated on a timely basis, including prior to the

issuance of the auditor's report. In addition, such monitoring enables consideration of similar deficiencies that might be present on other in-process engagements.

- **Increasing supervision of the work performed by specialists** – Many audit firms use auditor specialists, in particular when auditing complex estimates. Some auditors increased their level of oversight of the work of specialists to enhance communications in order to better understand the procedures performed and determine that such procedures are responsive to the risks identified.
- **Use of practice aids to assist engagement teams in identifying risks for each factor relevant to management's estimation processes** – Certain audit firms developed practice aids that include examples of risks at the assertion level for certain significant accounts involving accounting estimates to help engagement teams identify risks of material misstatement. For example, audit firms identified risks for auditors to consider in evaluating possible external or public company-specific factors that can affect the judgments involved in determining accounting estimates or create pressures to manipulate significant assumptions to achieve certain financial targets. Such improvements made by audit firms to their risk assessment process enhance the ability of engagement teams to identify and address all risks of material misstatement.

At some smaller audit firms, we observed the following practices:

- Monitoring workload and expertise of engagement quality reviewers and hiring qualified and experienced third-party engagement quality reviewers when audit firms have no expertise, or insufficient expertise, internally to perform an EQR.

- Providing focused industry training and tailoring work programs dealing with industry-specific risks and issues, including purchasing such materials from third parties as necessary.

## OTHER OBSERVATIONS

A strategic goal of the PCAOB is to anticipate and respond to the changing environment, including emerging technologies and related risks and opportunities. As part of achieving this goal, we reviewed how auditors are responding to technology developments, namely cybersecurity incidents and distributed ledger technologies.

Observations related to the audit firms' use of software audit tools are included in the Spotlight, **Data and Technology Research Project Update, May 2021**.

### Cybersecurity

Cybersecurity incidents remain prevalent, and the risks to public companies continue to evolve, presenting a risk of financial loss, disruption, or damage to the reputation of an organization. We continue to review audits of public companies that experienced a cybersecurity incident during the audit period. We observed in our reviews how the auditor considered the cybersecurity incident in their risk assessment process and, if applicable, in their response to identified risks of material misstatement. In certain audits reviewed, the auditor evaluated

the severity and impact of the cybersecurity incident but did not consider whether the incident affected their identification or assessment of risks of material misstatement; whether modifications to the nature, timing, or extent of audit procedures were necessary; and whether the incident could be indicative of one or more deficiencies in ICFR.

### Distributed Ledger Technologies and Digital Assets

We continue to observe limited instances in which public companies used distributed ledger technology to support recording a digital asset in their general ledger. When transactions are material and selected for review, we have identified deficiencies in which the auditor did not perform procedures to evaluate the sufficiency and appropriateness of audit evidence obtained over the existence and valuation of cryptoassets recorded at year-end.

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